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No. 88-1142

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1988

JAMES HELBA, JR., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

WILLIAM C. BRYSON
Acting Solicitor General
JAMES I.K. KNAPP
Acting Assistant Attorney General
GARY D. GRAY
Attorney

Department of Justice
Washington, D.C. 20530
(202) 633-2217

QUESTION PRESENTED

Whether the courts below correctly determined that certain partnership purchase transactions lacked economic significance beyond expected tax benefits and hence should not generate those tax benefits.

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OPINIONS BELOW

The judgment order of the court of appeals (Pet. App. 2-3) is reported at 860 F.2d 1075 (Table). The opinion of the Tax Court (Pet. App. 12-62) is reported at 87 T.C. 983. The supplemental opinion of the Tax Court (Pet. App. 5-10) is reported at 54 T.C.M. (CCH) 900.

JURISDICTION

The judgment of the court of appeals was entered on September 9, 1988. On November 28, 1988, Justice Brennan extended the time for filing a petition for a writ of certiorari to and including January 7, 1989. The petition was filed on January 6, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a financial planner. In 1978, he met with Lawrence Scheer, founder of Century Video Corporation (Century), to discuss investing in videotapes. The

following year, petitioner recommended to his financial planning clients the purchase of master video recordings marketed by Century for reproduction and distribution. None of the master videotapes sold by Century, including those sold to petitioner's clients, has ever returned any income to its individual investors. Pet. App. 14-17.

During the period from 1979-1981, petitioner formed four partnerships to purchase master videotapes from subsidiaries of Century and of Bard Productions, Ltd. (Bard), another company formed by Scheer. Two of the partnerships bought children's television series consisting of 13 episodes. The other two partnerships each purchased a videotaped production of one of William Shakespeare's plays. Pet. App. 27-29. Each purchase transaction followed a model developed by Scheer, in which the stated price was set without negotiations at either $2,300,000 or $2,320,000. Each partnership paid roughly 10% of the stated purchase price in cash and gave the Century or Bard subsidiary a note for the balance. The limited partners contributed cash to the partnership and executed agreements that made them personally liable for a pro rata portion of the partnership note. The agreements provided that the liability of the limited partners would terminate upon the occurrence of specified contingencies, which related to the number of video cassette and video disk players purchased in the United States and the amount of revenues generated by the tape. Pet. App. 17-19, 30-31.

The partnership notes were nearly identical in all material respects. The outstanding principal on each note, together with accrued but unpaid interest, was payable on February 1 of the eighth year following the year in which the note was executed. The notes bore stated interest at a rate of nine percent; interest in excess of $52,000 per year could be accrued and added to principal. The effective interest rate was considerably higher than nine percent, how-

ever, because of the manner in which the principal amount was calculated. The principal amount of the note was not simply the estimated cost of production minus the cash down payment; instead, that deferred amount was increased by capitalizing it at an annual interest rate of 20%, and this "capitalized" amount in turn was increased by approximately 25% in order to provide the seller with a further profit. Pet. App. 18-19. The result was that, although the estimated cost of each production was $725,000 and a cash down payment of at least $230,000 was made in each case, the principal amount of the note in each case exceeded $2 million. See *id.* at 19, 30.[1] Thus, the arrangement provided for the payment by the partnerships of amounts that were equivalent to an effective rate of interest on the deferred portion of the estimated cost of the production far higher than the stated rate of interest on the notes. See *id.* at 52.[2]

Each partnership offering memorandum stated that investment in the partnership was suitable for persons in the 50% tax bracket, explaining that the "relative financial benefit of an investment in the Partnership will generally

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[1] The $725,000 figure for the estimated cost of production did not represent actual cash outlays for the production of the videotapes. The producer paid for the cost of the production with "minimum cash payments and deferred obligations" (Pet. App. 18), which took the form of notes payable in part out of the revenues from distribution (*id.* at 55).

[2] Because the notes provided for annual payments of no principal and less than all interest due, the calculation of an effective interest rate is not a simple one. The Tax Court computed the effective interest rate at 52% (Pet. App. 52-53). In the court of appeals, the government argued that the effective rate was 29% and petitioner argued that it was "only" 26% (see Pet. 19). At all events, the partnership notes bore interest at an effective rate well above the 9% stated interest rate, as well as the 20% rate that petitioner contended in the Tax Court was "reasonable" for the period in question (see Pet. App. 52).

depend substantially on the tax bracket of the investor" (Pet. App. 20). Although the offering memoranda extensively discussed the tax implications of the investment, they did not represent that the purchase price reflected the fair market value of the videotapes or that the projected production cost was a reasonable one (*id.* at 22-23). The memoranda disclosed that the general partners lacked experience both in acting as general partners of a limited partnership and in videotape production, distribution and exploitation. The memoranda explained that the general partners would rely substantially on the efforts of the executive producers and distributors of the videotapes, but noted that they also were inexperienced. *Id.* at 25-26.

2. During the years 1979, 1980, and 1981, the partnerships reported annual losses ranging from $120,667 to $881,243. The partnerships that invested in the children's series received income during the years 1979-1984 totalling between $5,000 and $10,000. One of the partnerships that purchased a videotape of a Shakespeare play received distribution revenues totalling between $3,000 and $4,000 during 1981-1984. The other partnership that invested in a Shakespeare videotape received no income through 1984. Pet. App. 45.

During 1983 and 1984, each of the partnerships fell in arrears on minimum interest payments due under the notes. Although the notes provided that such a default allowed the holders of the notes to accelerate the partnerships' obligations for unpaid principal, the obligations had not been accelerated, and Scheer did not intend to cause Century or Bard to accelerate the notes. Pet. App. 45-46.

3. As a partner in each of the partnerships, petitioner reported his distributive share of losses and investment tax credits on his 1979, 1980, and 1981 federal income tax returns. The Commissioner determined deficiencies in petitioner's taxes for those years based largely on the

denial of these claimed losses and credits. Petitioner sought redetermination of the deficiencies in the Tax Court.

After a lengthy trial, the Tax Court ruled for the government (Pet. App. 12-62). The court found that the purchase transactions were shams, "completely lacking in economic substance" (*id.* at 47), and accordingly it denied the claimed tax benefits related to the transactions (*id.* at 46-60). The court identified several facts that supported this conclusion: that there was no arm's-length bargaining and the investors did not attempt to determine whether the prices they were paying were reasonable (*id.* at 48-51); that the terms of the notes amounted to an effective interest rate on the actual investment well in excess of what any reasonable investor would pay on an investment entered into for economic reasons (*id.* at 51-54); that the terms of the notes were not enforced (*id.* at 54-56); and that the offering memoranda were so dominantly focused on tax considerations that "it is unfathomable that a reasonable person could believe that there was a basis for investing in the partnerships other than for the acquisition of tax benefits" (*id.* at 57). Thus, the Tax Court concluded that "[t]he totality of facts and circumstances establish that the purchase transactions here in issue were in substance shams lacking economic significance beyond expected tax benefits" (*id.* at 60). The court of appeals affirmed in a judgment order "essentially for the reasons set forth" by the Tax Court (*id.* at 2).

ARGUMENT

Petitioner contends (Pet. 19-26) that the courts below erred in finding that the videotape purchase transactions lacked economic substance. This contention is without merit. The evidence fully supports the conclusion of the

courts below. Moreover, that conclusion is entirely fact-bound, and it presents no issue warranting review by this Court.

1. Petitioner mistakenly contends (Pet. 19-23) that the Tax Court, affirmed by the Third Circuit, has unduly "expanded" the economic substance doctrine beyond the scope permitted by this Court. The cases cited by petitioner, *Knetsch* v. *United States,* 364 U.S. 361 (1960), and *Frank Lyon Co.* v. *United States,* 435 U.S. 561 (1978), do not purport to articulate a rigid test by which to measure whether transactions have economic substance or to hold that the doctrine can be applied only in factual situations closely analogous to the ones presented in those cases. Rather, where a court determines that the transaction in question was not designed to "appreciably affect * * * [the taxpayer's] beneficial interest except to reduce his tax" (*Knetsch* v. *United States,* 364 U.S. at 366), the transaction should be treated as a sham for tax purposes, and the purported tax benefits are appropriately denied.[3] This inquiry is necessarily a factual one. See, *e.g., Sochin* v. *Commissioner,* 843 F.2d 351, 355 (9th Cir. 1988), cert. denied, No. 87-2026 (Oct. 3, 1988); *Mahoney* v. *Commissioner,* 808 F.2d 1219, 1220 (6th Cir. 1987); *Boyter* v. *Commissioner,* 668 F.2d 1382, 1388 (4th Cir. 1981). On the facts here, the Tax Court correctly found that the partnerships' videotape purchases were economic shams—not

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[3] Indeed, petitioner's narrow reading of this Court's decisions is inconsistent even with the formulation of the sham inquiry in the case upon which petitioner relies most heavily, *Rice's Toyota World* v. *Commissioner,* 752 F.2d 89 (4th Cir. 1985). There, the court stated that a transaction is a sham if the court finds "that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists" (*id.* at 91).

because they were paper shuffles or "hocus-pocus" (*Knetsch,* 364 U.S. at 370 (Douglas, J., dissenting))—but because they were carried out solely to achieve tax objectives and not to generate an economic profit. See, *e.g.*, *Collins* v. *Commissioner,* 857 F.2d 1383, 1385 (9th Cir. 1988).

The bulk of petitioner's submission (Pet. 3-18) is devoted to a recitation of material in the record, based upon which petitioner asserts (Pet. 23) that his "business purposes * * * were undisputed at trial" and that he "reasonably expected to generate a profit" from the transactions. These assertions, however, are directly contrary to the Tax Court's findings that were based upon a thorough review of the voluminous record and were affirmed by the court of appeals. The Tax Court found it "unfathomable that a reasonable person could believe that there was a basis for investing in the partnerships other than for the acquisition of tax benefits" (Pet. App. 57) and that "the transactions * * * were not structured with the intent of conforming to economic realities but rather were entered in order to obtain tax benefits" (*id.* at 56). Petitioner seeks to reargue the evidence introduced at trial, and there is no reason for the Court to deviate here from its general practice of declining to review factual findings concurred in by both lower courts. See *Tiffany Fine Arts, Inc.* v. *United States,* 469 U.S. 310, 318 n.5 (1985); *United States* v. *Reliable Transfer Co.,* 421 U.S. 397, 401 n.2 (1975); *Berenyi* v. *Immigration Director,* 385 U.S. 630, 635-636 (1967).

In any event, the courts below correctly concluded that this record demonstrated that the transactions lacked economic substance. Based on its examination of the objective facts, the Tax Court correctly rejected petitioner's testimony professing his belief in the profit potential of the transactions. The evidence clearly supports the court's conclusion (Pet. App. 48-51) that the various agreements

entered into by the partnerships were not the result of arm's-length negotiations. Petitioner, who as general partner acted for the partnerships, was a neophyte in the field of video production and distribution (*id.* at 15). The promoter offered the videotapes at a fixed, non-negotiable price, and petitioner made no effort to determine whether the price had any reasonable relation to production costs or expected revenues. In fact, the prices of the products sold to each partnership were virtually identical, despite the dissimilarity of product and production arrangements. See *id.* at 48-50. As the Tax Court noted (*id.* at 50), this remarkable coincidence is "indicative of transactions that have been contorted to fit into a standardized tax model, rather than being structured to fit economic realities."

Each of the partnerships was burdened with inflated debt obligations. See Pet. App. 51-54; note 2, *supra.* Although such inflated obligations were not compelled by economic considerations, they were essential to the partnerships' tax objectives. The notes were included in the bases for depreciation of the videotapes and for investment tax credits, thereby creating the opportunity for the partnerships to return more in tax savings to the limited partners than the partners contributed in cash. Although the notes purported to represent recourse obligations, *i.e.*, obligations for which the partners would be personally liable if the partnership did not meet them, the Tax Court correctly found (*id.* at 56) that it was doubtful that the parties ever intended to enforce the notes in accordance with their terms. Although each of the partnerships had fallen in arrears on their payments under the notes, their obligations had not been accelerated, and the court found that Scheer did not intend to take such action against the partnerships (*id.* at 45-46).

Finally, the partnership offering memoranda advanced no inducement to invest in the partnerships aside from the

tax benefits. See Pet. App. 56-57. The memoranda disclosed, among other things, that the general partners, as well as the producers and distributors of the videotapes, had little or no experience in the business. The absence from the memoranda of any reason for optimism concerning the partnerships' economic prospects was fully justified: at the time of trial, none of the partnerships had returned any profits to its investors. These facts support the Tax Court's finding that the transactions lacked economic substance and were entered into for the purpose of creating tax benefits that would exceed the investor's cash outlays. There is no reason for further review of that factual conclusion.

2. Petitioner contends (Pet. 24-26) that the Court should grant certiorari here to resolve a conflict between the decision below and the Fourth Circuit's decision in *Rice's Toyota World* v. *Commissioner,* 752 F.2d 89 (1985). This contention is without merit. First, the court of appeals' unpublished judgment order in this case plainly does not adopt any legal principle that could be said to conflict with a decision of another court of appeals rendered in a completely different factual context. In any event, there is no conflict between the result in this case and that in *Rice's Toyota World;* the different results are simply a consequence of the different facts in the two cases.

In *Rice's Toyota World,* the court of appeals held that, although a computer sale and leaseback lacked economic substance, a short-term recourse note securing part of the purchase price did not. Accordingly, the court ruled that interest on the note was deductible. Petitioner contends that the courts here "ignor[ed]" (Pet. 25) the economic substance of the recourse notes in this case and that their failure to permit deducton of the interest on those notes

conflicts with the Fourth Circuit's decision in *Rice's Toyota World*. This contention is mistaken.

The Tax Court did not ignore the recourse designation of the partnership notes, but rather found that other relevant circumstances contradicted that designation. As with the purchase transaction as a whole, the substance, not the form, of the notes dictates their tax treatment. See, *e.g.*, *Bridges* v. *Commissioner*, 39 T.C. 1064, 1077, aff'd, 325 F.2d 180 (4th Cir. 1963); *Roe* v. *Commissioner*, 52 T.C.M. (CCH) 778, 797 (1986), aff'd, 841 F.2d 394 (5th Cir. 1988) (Table). Here, the Tax Court's findings fully support the conclusion that, despite the characterization as recourse obligations, there was little economic incentive for payment of the partnership notes. The note obligations were inflated, the tapes were producing no revenues for the partnerships, and, although the partnerships had fallen in arrears, Scheer brought no action to collect the amounts in default. Moreover, the courts below correctly rejected the contention (see Pet. 26) that the partnership notes had substance because they could be enforced by "literally hundreds of persons." The Tax Court found (Pet. App. 54-56) that the liability of the executive producers to third parties, who might theoretically enforce the partnership notes as third-party beneficiaries, was structured to minimize the possibility of enforcement. In sum, in contrast to the factual conclusion in *Rice's Toyota World* that the recourse note there was an "obligation of economic substance" because the investor could not "walk away without liability from the deferred principal and interest obligation" (752 F.2d at 96), petitioner failed to prove that the notes in this case had economic substance. Therefore, the courts below correctly refused to treat the notes as genuine debt.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General
JAMES I.K. KNAPP
Acting Assistant Attorney General
GARY D. GRAY
Attorney

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